Internal Revenue Service
memorandum

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to: Ken Voght
Staff Assistant, Examination Division
Buffalo District

from: Acting Associate Chief Counsel (International) CC:INTL

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subject: Procedure to be Followed in Assessing Tax Against Canadian Taxpayers who have earned U.S. Source Rental Income but have never filed U.S. Tax Returns

You are in the process of trying to assess tax on certain Canadian taxpayers and have asked us for advice concerning the method most likely to result in the assessment being sustained and ultimately collected. This letter is in response to that query.

FACTS

You have identified[1] approximately 40 Canadian[2] taxpayers who, in 1985, owned real property in the Buffalo area, earned U.S. source rental income, and did not file U.S. income tax returns or make any elections with respect to the property. You have drafted thirty-day letters to these taxpayers. The letters assert proposed deficiencies based on the gross rent paid on the U.S. property. No deductions are allowed, as the taxpayers have neither filed U.S. returns, nor elected to treat their rental income as effectively connected to a U.S. trade or business (ECI).

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[1]/ To obtain the names and addresses of these persons, you went to certain local real estate agents, which you believed were managing rental real property for the Canadian taxpayers. You informed them that if they had collected rent on behalf of Canadian taxpayers, they were liable for deducting and withholding tax on the rental income under I.R.C. sections 1441 or 1442. Although the real estate agents are liable for payment of the tax under section 7501, you evidently agreed, in exchange for the names and addresses of the Canadian owners, not to immediately assess the deficiency against the real estate agents until you had attempted to collect from the owners of the property.

[2]/ The taxpayers may be either nonresident aliens or Canadian corporations without a U.S. permanent establishment.

DISCUSSION

Income tax is imposed on U.S. source gross income (which is not ECI) of nonresident alien or foreign corporate taxpayers (foreign taxpayers) at a rate of 30%. See, IRC sections 871(a) and 881(a). ECI earned by such persons is taxed on the net amount at the standard rates imposed by sections 1 and 11. See, sections 871(b) and 882(a). Pursuant to section 871(d) and 882(d), foreign taxpayers may elect to treat rental income, which is not ECI, as if it were ECI, so that the ordinary and necessary expenses allocable to that income will be deductible to reduce the amount of income subject to tax. The election is made by filing an election with their return for that taxable year. See section 1.871-10(d) of the regulations.

Under sections 874(a) and 882(c), foreign taxpayers are entitled the benefit of deductions and credits only if they file "a true and accurate return, in the manner prescribed in subtitle F", which includes sections 6001 through 7873. Section 6072 prescribes deadlines for foreign taxpayers to file their returns. This provision, under a variety of sections, has been a part of IRC the since the 1918 Code.

In Anglo-American Tea Trading Co., LTD. v. Commissioner, 38 BTA 711 (1938), the question of whether the phrase "in the manner prescribed by this title" includes the timeliness requirement contained in the predecessor to section 6072 was discussed at length. In Anglo-American, in the course of an IRS audit of the U.S. subsidiary, an IRS agent asked an officer of the company whether its parent had filed U.S. returns with respect to dividends paid by the U.S. sub. Upon ascertaining that none had been filed, the agent prepared and submitted delinquent returns to the agent in charge. These returns reported tax due based on the parent's gross income without the deduction for dividends received to which the parent would have been entitled, had it claimed the deduction on a return. Three days later the parent prepared and filed delinquent returns, claimed the dividends received deduction and reported no net income. On audit the deduction was denied. The taxpayer stipulated that its returns were late and the IRS moved for a judgement on the pleadings. The court denied the motion because it held that "in the manner prescribed by this title" did not include the time limits prescribed in the title.

Prior to December 10, 1990, the regulations under sections 874 and 882(c)[3] provided that foreign taxpayers would receive

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[3]/ The regulations, sections 1.874-1(b)(1) and 1.882-4(b)(3), effective for taxable years ending after July 31, 1990, now provide that nonresident aliens (NRA) and foreign corporations (FC) must meet specific deadlines for filing returns

the benefit of deductions if they filed true and accurate returns in accordance with section 6012. Section 6012, among other things, provides that foreign taxpayers must file returns; it has no provision dealing with time limits for filing those returns. Section 1.874-1(c) and 1.882-4(b)(3) of the regulations, as they read prior to December 10, 1990, provided that if a foreign taxpayer earned U.S. source income and failed to file a return, the District Director might make a return including all U.S. source income, without deductions, and assess the tax due thereon.

The issue of when a foreign taxpayer will be precluded from claiming deductions has been considered by the Fourth Circuit (the proper venue for appeals of Tax Court cases involving foreign corporations under section 7482(b)). In Ardbern Co., Limited v. Commissioner of Internal Revenue, 120 F.2d. 424 (1941), the taxpayer attempted to file a delinquent return with an IRS agent, who rejected it because it had not been properly signed, but failed to tell the taxpayer that it should have been filed with the Collector of Internal Revenue at Baltimore, Maryland. Shortly thereafter a Deficiency Notice was mailed to the taxpayer and substitutes for returns were prepared by IRS agents. The tax shown on the returns and the deficiency notice was calculated using the taxpayer's gross income without deductions, even though the government was on notice that the taxpayer had claimed deductible items. After the petition was filed, the taxpayer filed its returns in Baltimore when it learned that the commissioner had taken the position that the original returns had not been properly filed.

At trial, the government conceded that, if the taxpayer's first attempt to file had been successful, the taxpayer would have been entitled to the deductions claimed. The Court held that, since timeliness is not incorporated in the phrase "in the manner of", and since the service acted in bad faith with respect to the filing of the taxpayer's delinquent return (by not informing it where to file), the taxpayer was entitled to claim its deductions in a return filed after the deficiency notice was mailed.

Eight months later, the second Fourth Circuit opinion,

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in order to claim most deductions and credits. NRAs generally must file within 16 months of the due date of the return provided in IRC section 6072. However, if for years prior to the effective date of the regulation, the NRA failed to file required returns, the deadline is the earlier of 16 months or the date the IRS mails a notice to the NRA advising the no return has been filed and that no credits or deductions may be claimed. The rules for FCs are nearly identical, except that the grace period is 18 months.

Blenheim Co., Ltd. V. Commissioner of Internal Revenue, 125 F.2d. 906 (1942), held that a foreign taxpayer who filed its tax return four years late, after the IRS had filed a substitute for return, was not entitled to the deductions claimed. In this case the Commissioner repeatedly solicited a return for the taxpayer, and, after failing to get any response, filed the substitute return. Ardbern, Supra., was distinguished on the basis that the taxpayer there had attempted in good faith to file a return, and the Commissioner, knowing that there were deductions claimed, nevertheless filed a substitute which failed to mention them.

In Blenheim, on the other hand, although the taxpayer had pled ignorance of the filing requirement, the court was unmoved because the IRS had made every effort to get the taxpayer to file before making a substitute. As the court opined:

> Without prescribing an absolute and rigid rule that whenever the commissioner files a return for a foreign corporation the taxpayer is completely and automatically denied the benefit of deductions or credits, we yet hold that the facts of the instant case justify a disallowance of deductions which the petitioner might otherwise have been entitled to claim, had it filed a timely return in compliance with the statutory requirement. (at p. 910)

All of the cases dealing with this issue involve substitutes for return filed by the Commissioner. The question of whether the Commissioner must make a return in the situation where a taxpayer has failed to file a return was settled in Hartman v. Commissioner, 65 T.C. 542 (1975). In Hartman, the taxpayer filed a "protester" return (which the Court considered a nullity) that reported no income or tax due. When the IRS mailed a Deficiency Notice, the taxpayer petitioned and argued that the Code allowed the Commissioner to assess only taxes shown on a return filed by the taxpayer or on a return prepared by the Secretary of the Treasury. After an analysis of the legislative history of section 6020, the Court concluded that the making and filing of a return is not a prerequisite to assessing the tax.

CONCLUSION

You have proposed to immediately issue thirty-day letters to the taxpayers, and then to issue Statutory Notices to any who do not pay the proposed deficiency. However, based on the case law and the voluntary nature of our compliance system, we believe it more prudent to send the taxpayers a letter, which notifies them

that a return is required, tells them where and when it must be filed, and informs them that a statutory notice of deficiency will follow if they do not file a return within 30 days.

If you have any questions, you may contact Christine Halphen at FTS 377-9493, or James H. W. Insley at FTS 566-4411.

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